

# *Full Employment and Free Trade: An Historical Episode of Australian Intellectual Leadership*

By

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## **Abstract**

In the 1940s Australian economists sought an international agreement that would bind countries to the pursuit of full employment. Seen by them as a necessary prerequisite to agreements on monetary and commercial policy, this 'employment approach' was advanced with a 'crusading zeal' before the great international conferences concerned with postwar reconstruction. Sometimes regarded as Australian posturing, the employment approach was based on a sound understanding of contemporary economic theory. The purpose of this paper is to reappraise the employment approach in terms of this theory. It concludes that the Australian economists were correct in their advocacy, and their actions a timely reminder of a period when Australia sought to positively engage the international community.

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...we have had our final banquet and celebration. The love feast was completed by the two black sheep, the Australians and the Russians, receiving their telegrams in time...amidst loud and continued applause, and embraces all round, the erring sheep were received into the fold (Keynes 1980, p.112).

## **I. Introduction**

The tension between internal and external balance has been a perennial dilemma in Australia's economic history. A dilemma that has created some of the most original and characteristic features of the nation's political economy, it has also prompted some of the more extreme episodes of national defensiveness in dealing with the rest of the world.

In the 1940s it inspired a bold and positive response. Widely known as the 'employment approach', this response took the form of an Australian proposal to establish an international agreement binding countries 'to do all in their power to maintain employment within their own territories, and thereby expand demand for internationally-traded goods'. This policy informed Australia's economic diplomacy throughout the 1940s and was the product of H.C. 'Nugget' Coombs, L.F. Giblin, Leslie Melville, and other influential economists from this 'golden age of Australian economics'.<sup>1</sup> Devised initially in response to pressure from the United States for a system of free trade and payments in exchange for 'lend-lease' aid, the 'employment approach' was motivated by the concerns for external balance, but it was also self-consciously an attempt to apply the economics of Keynes on a global scale.

Advocacy of the employment approach primarily took place at the great international conferences concerned with the postwar reconstruction of the global economy and its institutions. But, as Keynes's comments from his final report on Bretton Woods above indicate, it was not always welcome. A persistent irritant to the great powers, it was largely seen as an unnecessary complication to what were regarded as the more important tasks of deciding upon new monetary and trading regimes. Such is the past with us still.

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<sup>1</sup> Groenewegen and McFarlane (1990).

As an historical narrative, the employment approach has been examined before. The wartime conferences and the role of the Curtin/Chifley Labor governments in its propagation are examined in a volume of Australia's official war history (Butlin and Schedvin 1977). Elsewhere, surviving protagonists have told of their experiences (Crisp 1965, Coombs 1981, Tange 1996). The approach has also been examined as an episode in Australia's diplomatic relations, especially with the United States, and its emerging place in the postwar world (Beresford and Kerr 1980, Lee 1990, 1995, Lowe 1996). Finally the approach has been used in a limited extent in works that have attempted to account for the spread of Keynesian economics in Australia (Markwell 1985, Cornish 1994). What has been missing, however, has been an examination of the *economics* behind it. This is unfortunate. Condemned at the time as Australian posturing, a charge repeated in a number of the works above, an examination of the economic theory behind the employment approach reveals that its premises were largely correct.

The purpose of this paper is to examine the employment approach through the ideas of its economist advocates, rather than tracing its policy successes and failures and diplomatic trevails. The argument proceeds as follows: Section II examines the instigation of the employment approach in response to American pressure, and the initial shape that it took in the hands of Australian economists. Section III examines the consolidation of the approach under the direction of Coombs, and documents a little-known exchange with Keynes. Section IV re-appraises the employment approach according to contemporary economic theory, finding in favour of the approach overall. Section V concludes the paper.

## **II. The 'employment approach'**

### ***Article VII***

The 'employment approach' was devised in response to Australia's obligations under Article VII of the Mutual Aid Agreement with the United States. As a *quid pro quo* for the provision of 'Lend-Lease' aid to Britain and its allies in the Second World War, the

Mutual Aid Agreement set out the preferred payment option of the United States. This was not in money or in goods, but in the form of an agreement

for agreed action by the United States of America and the United Kingdom, open to participation by all other countries of like mind, directed to the expansion by appropriate international and domestic measures of production, employment and exchange and consumption which are the material foundation of liberty and welfare of all peoples; to the elimination of all forms of discriminatory treatment in international commerce and to the reduction of tariffs and other trade barriers...<sup>2</sup>

Article VII was the product of the State Department and, in particular, the Secretary of State, Cordell Hull. Hull had been a keen advocate of non-discriminatory free trade throughout his long term in office. Maintaining a Cobdenite conviction that trade barriers were the prime causes of war, Hull had used the United States' bargaining strength in the late 1930s to bring about a reduction in trade barriers via bilateral agreements. Faced now with the opportunity to deploy greater bargaining strength, Hull was determined to ensure that the elimination of trade restrictions became part of the war aims of the United States. Hull's idealistic convictions with regard to free trade were shared by many in the State Department, but free trade was popular in powerful sections of American society more generally. This was not least true of big business, a sector concerned about the rise of interventionism as manifested in the New Deal, and anxious about the preservation of American capitalism. Free trade, which the Roosevelt Administration always referred to as 'multilateralism', was a policy that reconciled a number of interests.

Britain's reaction to the first drafts of Article VII had been unfavourable. The references to the reduction in trade barriers and the elimination of discriminatory treatment were the sticking points, targeted as the latter was to the imperial preference schemes of the British Empire. The references in the final version of Article VII above to 'the expansion of employment and consumption' had only been inserted at the insistence of Keynes (in the United States in 1941 and handling the early negotiations over Article VII).

Notwithstanding their objections, in the face of mounting US pressure Britain duly signed off on Article VII, on 23 February 1942 (Gardner 1956, pp.60-62, Skidelsky 2000, pp.126-133).

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<sup>2</sup> The re-draft is reproduced in Gardner (1956), pp.58-59.

## *Australia*

The advice of Australia was not sought during these negotiations. Nevertheless, the Commonwealth Government was aware that they were taking place and in late 1941 an Inter-Departmental Committee on External Relations (ICER) was formed to consider the implications for Australia. Critically for what would emerge, the ICER included the economists of the Financial and Economic Advisory Committee (F&E) whose members included Giblin, Coombs, Melville, D.B. Copland, James Brigden, and Roland Wilson.<sup>3</sup> From the beginning, consideration of the *economic* implications of Article VII was the preserve of the economists of the F&E.

The parameters of the F&E's initial response to Article VII were established by Giblin. Advising against rejecting international cooperation in a world that he thought was likely to disintegrate into one where countries exploited 'economic, political and military advantages to secure favourable trade terms', Giblin urged 'a sympathetic understanding of the American viewpoint'. In this light, the most important thing Australia could do was to highlight the 'positive' aims of Article VII, 'the expansion of production, employment and the exchange and consumption of goods', to smooth the process.<sup>4</sup>

Giblin's assessment of the likely shape of the postwar world was widely shared within the F&E and two 'young' economists, Arthur Tange and Gerald Firth, were commissioned to write detailed memoranda on the issue. Circulated amongst the F&E in June 1942, these struck a decidedly Keynesian stance, their overall philosophy best summarised by Firth's opening declaration that

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<sup>3</sup> Giblin, the F&E's Chairman, had just retired as Ritchie Professor at the University of Melbourne, Brigden was Secretary of the Department of Supply and Development and Coombs was Economist at the Treasury. Copland had been appointed Economic Consultant to the Prime Minister by the previous Governments of Menzies and Fadden, and was retained in this post by the new Curtin Labor Government. Melville was Economic Adviser to the Commonwealth Bank and Wilson was then Commonwealth Statistician. Other members were co-opted when needed. For more details on the F&E, see Maddock and Penny (1983).

<sup>4</sup> 'Mutual Aid – Article VII', June 1942, National Archives of Australia (NAA), CP184/1, Bundle 4.

the “classical” theory of international trade is accepted throughout as being substantially correct, *and the same attitude has been adopted towards the Keynesian theory of employment* (emphasis added)<sup>5</sup>

Both memoranda were extraordinarily pessimistic with regard to the ability of the private sector alone to generate full employment, and to the constraints Australia would face in maintaining full employment because of likely external sector imbalances. They concluded that Australia’s hope for maintaining internal and external balance lay in international cooperation and that, given this, Australia ‘should energetically participate in the formulation of a *world* employment policy’ (emphasis in original).<sup>6</sup>

Tange’s and Firth’s memoranda were debated by members of the F&E and a final report of the Committee, which did not differ in any substantial way from their analyses, was printed in August 1942 and circulated to government ministers. It concluded with what the committee saw as the only solution to Australia’s dilemma:

If the principal countries of the world, and particularly [the] United States of America, adopted consistently and effectively the same policy to maintain employment, the danger in the export market might be much reduced.

With this in mind

international collaboration offers a fair prospect of escaping [Australia’s] difficulties...and taking part in a systematic upward movement of world prosperity which will benefit no country more than Australia ...It should be the policy of Australia to do everything possible to bring these aims and aspirations to a successful issue.<sup>7</sup>

### **III . Consolidation and Propagation**

The employment approach was sanctioned in these broad outlines by the government, and in this form was used in discussions with the UK and the other Dominions in talks in London in 1942. Its impetus from 1943 onwards, however, was primarily the result of the strong and well-placed advocacy of Coombs who, in December 1942, had been appointed

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<sup>5</sup> ‘Memorandum by Gerald Firth’, 24 June 1942, NAA CP13/1/1, 53. Tange’s memorandum, dated 18 June 1942, can be found in this same file.

<sup>6</sup> *ibid.*

<sup>7</sup> ‘Australia’s Position in Relation to Article VII’, 20 August 1942, NAA CP43/1/1, Bundle 5/1943/444/pt.1.

Director-General of the newly created Ministry of Post War Reconstruction (PWR). It was to this Department that the Government formally delegated responsibility for Australia's approach to the international conferences that were soon to be called on postwar reconstruction.

The PWR has assumed somewhat mythic proportions in Australia's political and economic history.<sup>8</sup> Conceived at the Annual Conference of the Australian Labor Party in 1942, it was a vehicle through which the Party could reconcile its inherent opposition to war, with the needs of a wartime government calling for sacrifices but with the promises of a new order to come. From the outset, the PWR was seen as an engine of social change whose task, according to Coombs, 'was to ensure an economic and social context in which positive opportunities were present rather than merely an absence of constraints' (Coombs 1981, p.26). These opportunities consisted primarily of employment and, as such, 'the Ministry was...identified from its inception with the idea of full employment' (Coombs 1981, p.26).

Coombs took a stronger line on the employment approach than his colleagues, desiring to 'establish beyond doubt' that Article VII was '*primarily*' about raising living standards via full employment.<sup>9</sup> Determined to establish the theoretical rationale for the employment approach within the context of orthodox trade theory, Coombs drew attention to its assumption of 'full employment in all the international trading states', in the absence of which the theory became 'largely irrelevant'.<sup>10</sup> It was Coombs's further belief that the level of national income, and hence the level of employment, was a far more important factor in the demand for traded goods than the extent of trade or exchange barriers. It followed, therefore, 'that policy designed to expand the volume of world trade is far more likely to be effective if it is directed towards the maintenance of income than if it is directed to towards altering the level of the tariff'.<sup>11</sup>

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<sup>8</sup> See, for just one example of this, Crisp (1961) pp.183-197.

<sup>9</sup> 'Article VII', NAA A606/1, 40/1/8.

<sup>10</sup> *ibid.*

<sup>11</sup> *ibid.*

In July 1943, Coombs wrote to Keynes, seeking his views about the employment approach.<sup>12</sup> Coombs was concerned not only to get Keynes's views about the general principles of international collaboration on employment, but also on a proposal that Australia take the initiative in calling for a conference which would seek a binding employment agreement.

Coombs's letter caused some concern in the British Treasury, whose opinion Keynes sought before making his reply. Sir Wilfred Eady, Second Secretary to the Treasury, wrote to Keynes that the letter was not 'quite so harmless as it looks'.<sup>13</sup> Referring to Coombs's efforts to have the maintenance of employment listed as one of the directives for whatever international monetary institution would emerge, Eady predicted (accurately) that Australia would likely seek such a clause listed in all agreements - a development that in the context of the broader Article VII negotiations would not likely 'produce anything very safe'.<sup>14</sup> Keynes replied to Coombs in three letters over August - September 1943. In them he wrote that there was no disagreement in London about the principle, but that the order of issues presented difficulties:

First, because the normal problems of unemployment are not very likely to arise immediately after the war and belong to the more normal conditions about which we can legislate at greater leisure. But also - and perhaps this is more important - because one may be forced to deal too much in generalities on this subject unless one has more knowledge than one has at present of the international institutions and instrumentalities through which one will be working.<sup>15</sup>

Notwithstanding his view that a conference on employment at this point would be premature, Keynes sought to assure Coombs that maintaining full employment was a goal which would be placed 'to the forefront' of Article VII negotiations with the United States.<sup>16</sup> He also did not discount the possibility that at some later stage an international employment conference 'might be of help both in educating public opinion in the various

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<sup>12</sup> Long thought to be missing, and not mentioned in Coombs's autobiography or in any other source, it was rediscovered by the author in 1994. The letter, dated 17 July 1943, can be found in 'Lord Keynes' Papers', Treasury Records, Public Record Office, United Kingdom (PRO), T247/84, 15587.

<sup>13</sup> Eady to Keynes, 6 August 1943, 'Lord Keynes' Papers', *op.cit.*

<sup>14</sup> *ibid.*

<sup>15</sup> Keynes to Coombs, 12 August 1943, PRO T247/84, 15587.

<sup>16</sup> Keynes to Coombs, 3 September 1943, *ibid.*

countries and in facilitating the international acceptance of whatever plans may ultimately be agreed upon in the monetary, commodity, commercial and investment fields'.<sup>17</sup>

Keynes's correspondence with Coombs was thinly diplomatic, but in an earlier exchange with Sir Frederick Phillips of the British Treasury he voiced his concerns that the Australian approach on employment could interfere with the plans on monetary and other issues. Writing in May 1943, he told Phillips that at the talks with the United States Treasury the previous year he had been

rather impressed by the very small amount of progress the Australians really made in clearing matters up. They seem to have wasted a good deal of time discussing full employment and came away not knowing very much more about it all than they knew when they went in.<sup>18</sup>

### ***Official Policy***

Keynes's less than encouraging replies to Coombs coincided with events in Australia that were to firmly entrench the employment approach as Australia's chosen instrument in international negotiations, and made it the formal policy of the Australian government.

The key to this was the Minister for External Affairs, Dr. H.V. Evatt. Evatt had used the employment approach in negotiations during visits to the US and the UK in 1943 (accompanied by Coombs, who spoke to Keynes as well as to Harry White, author of the Stabilisation Fund proposal that was in competition with Keynes's Clearing Union as the

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<sup>17</sup> *ibid.*

<sup>18</sup> Keynes to Sir Frederick Phillips, 8 June 1943, 'Lord Keynes' Papers', *op.cit.* Keynes's attitude to the employment approach was also apparent in a letter to T.S. Eliot in April 1945 in which he wrote:

Not so long ago I was at a Conference where the Australians urged that all the Powers in the world should sign an international compact in which each undertook to maintain full employment in their own country. I objected on the ground that this was promising to be 'not only good but clever'...

...the main task is producing first the intellectual conviction and then intellectually to devise the means. Insufficiency of cleverness, not of goodness, is the main trouble... (Keynes 1980, pp.383-384).

model for the postwar monetary order). In January 1944 Evatt used the approach as the centrepiece of a Cabinet submission in which he sought authority for an agreed stance to take to the host of international conferences scheduled that year.<sup>19</sup> The approach was justified in Evatt's submission on the basis that international machinery concerned with monetary and commercial policies could only operate successfully if all countries, but especially the larger ones, maintained high levels of employment.

Evatt's submission was approved by Cabinet and, although ultimately only one of a triumvirate (with Curtin and Chifley) in overseeing Australian foreign policy, he was from this moment the Minister most identifiably in charge of Australia's external economic relations. Evatt had very little idea of economics, but the employment approach was handily consistent with other objectives for postwar reconstruction that he loudly championed in the international arena. These, which included the creation of structures to apply legal principles to international affairs in the pursuit of social justice, national self determination, universal human rights and other objectives that Lowe (1996, p.177) collectively categorised as 'international liberalism', were in turn primarily motivated by the objective to give 'voice' to Australia as a 'middle power' with regional ambitions.<sup>20</sup>

Now that it was government policy, the employment approach had to be drafted beyond being simply a statement of broad principles, and into something more concrete upon which to base negotiations. This task was completed largely within PWR by Coombs and Tange, with substantial input from Melville. The formal document they prepared, titled a 'Draft International Employment Agreement', opened with the commitment that

each signatory government recognises and hereby undertakes a national obligation to its own people and an *international obligation to the other signatory governments* henceforth to take all measures necessary to provide such opportunities for its people that all who are able and willing to work may do so [emphasis added].<sup>21</sup>

To bring this about, signatory governments would also have to undertake:

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<sup>19</sup> 'United Nations Economic Proposals', Full Cabinet Agendum No.594, NAA CP184/1, Bundle 4.

<sup>20</sup> There has, of course, been much written about Evatt and of his ambitions for Australia during his time as Minister for External Affairs. For one of the most recent and objective accounts, see Lee (1995).

<sup>21</sup> *ibid.*

- (a) to consult with other governments and with appropriate international authorities on methods of collecting detailed statistics of national employment and unemployment...;
- (b) to submit, at intervals not exceeding three months, such statistics to other governments and...through an appropriate organisation;
- (c) to report to other governments and representatives of international monetary and other authorities at an annual conference on the state of employment of its people and to provide information to the other governments and authorities about economic policies which have been used or are contemplated to combat unemployment;
- (d) to meet with other governments and authorities at a special conference called by an appropriate organisation, if, in the opinion of that organisation, the level of unemployment in any signatory country represents a serious failure on the part of that country to observe the responsibilities herein declared to its own people and to other signatory countries, for the purpose of examining and reporting upon possible national and international measures to restore the level of employment and to prevent the spread of unemployment to other countries.<sup>22</sup>

The Draft Agreement labeled the level of unemployment in any one country which would ‘trigger’ censure as its ‘quota’. Should a country exceed its quota, it would be required ‘to consider’ measures such as:

- (a) stimulation of private investment;
- (b) increase in public investment;
- (c) increased consumption expenditure;
- (d) expansion (under appropriate circumstances) of overseas investment.<sup>23</sup>

Curiously, tax cuts were not mentioned as a policy instrument. The Draft Agreement envisaged that the ‘appropriate organisation’ overseeing all of this would consist of little more than a ‘small secretariat’, and would rely on other organisations, particularly the International Labour Organisation (ILO), for research and the collection of data.

### ***The Conferences***

Formalised, and official government policy, the employment approach formed the basis of Australia’s negotiating positions during the meetings to consider international postwar reconstruction in 1944 and 1945 – at the meeting of Commonwealth countries in London

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<sup>22</sup> *ibid.*

<sup>23</sup> *ibid.*

in February 1944, at the annual ILO convention in Philadelphia in April 1944, at the monetary conference at Bretton Woods in July 1944, and at the meeting establishing the United Nations, in San Francisco, in April-June 1945. At all of these it was essentially brushed off with what to Australia would become a familiar litany – this was not the right time, there had to be monetary/trade/other agreements first, this was not the right conference to bring the issue up, and so on.<sup>24</sup>

One success that did occur was to get British agreement at the Commonwealth meeting in London to join with Australia in approaching the US to host a stand-alone employment conference. According to Butlin and Schedvin (1977, p.658), this was agreed by the UK to deflect Australia's advocacy, 'to create a diplomatic carousel which Australia could enjoy harmlessly'. There was some truth to this, and certainly Keynes and some other officials thought that the Americans would give short shrift to Australia's line. It was not the complete truth, however, and it ignores the extent to which similar proposals were then being prepared within the UK itself. Unbeknownst to Australia, for example, James Meade's proposal for a 'Commercial Union' had been advanced by British officials during discussions with the US in 1943. This proposal, though not yet government policy, had the support of a number of British ministers and contained within it a draft 'International Employment Policy' that was remarkably similar to the employment approach. Of course, it must also be remembered that at this time the finishing touches were being put to Beveridge's extraordinarily influential report, *Full Employment in a Free Society*, which contained within it a consideration of international issues. The British Government's own 'White Paper' on full employment was also soon to appear. In short, ideas such as those behind the employment approach were hardly strangers in political and economic circles in the UK and were not only respectable but, increasingly, becoming policy.

In the end the US refused to entertain an international conference concerned solely with employment, which it regarded as a purely domestic matter, but it agreed, following a

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<sup>24</sup> For accounts of the detailed advocacy at these conferences, see Butlin and Schedvin (1977), and Turnell (1999).

joint submission by Australia and the UK, to link employment to trade policy in the series of meetings designed to establish an International Trade Organisation (ITO). These talks took place in London in October 1946, Geneva in April 1947 and in Havana, Cuba, from November 1947 to March 1948. In its initial draft articles of the ITO, the US in fact did little in the way of linking trade and employment. In a story that has been told elsewhere though (see Capling 2000), Coombs, as head of the Australian delegation and with the backing of the UK, did manage to establish in the draft articles of the ITO precisely the links Australia had long sought. Article 3 committed members of the ITO to the recognition that ‘rising effective demand...is a *condition* for the expansion of international trade and...for the realization of the purposes of the organization’ (emphasis added).<sup>25</sup> Article 7 went even further, declaring the responsibility of persistent creditor nations in prolonging the balance of payments difficulties of other countries and their duty therefore to ‘make their full contribution to action designed to correct the maladjustment’.<sup>26</sup> Article 26 allowed quantitative restrictions for balance of payments purposes, especially when used for carrying out ‘domestic employment, reconstruction, development or social policies’.<sup>27</sup>

Australia’s apparent success in the negotiations over the creation of the ITO, however, were to prove a mirage. The failure of the US Congress to ratify the ITO Charter in 1950 meant that the Organisation never came into being. This, coupled with the defeat of the Chifley Government the year before and a growing optimism as to the prospects of the international economy, brought the employment approach to a close.

#### **IV. Theoretical Assessment**

Orthodox trade theory in the 1940s was built around the twin edifices of the Ricardo-Mill theory of comparative advantage, and the ‘price-specie flow’ mechanism of balance of payments adjustment. Though somewhat modified by later writers, the essential truth of the model of comparative advantage was (and is) regarded as an article of faith amongst

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<sup>25</sup> The London draft ‘Charter of the International Trade Organisation of the United Nations’ is cited from Australia, Parliament (1947).

<sup>26</sup> *ibid.*

economists. The exact nature of the price – specie flow mechanism enjoyed less unanimity, but the conventions of most of the approaches to the issue were established in the ideas of ‘classical’ writers such as Hume, Ricardo, Thornton and Mill. Of importance in the context of the employment approach, these were the theoretical apparatus that lay behind the US advocacy of multilateralism.<sup>28</sup> Of even more importance for the employment approach, however, both contained a number of questionable assumptions and propositions.

### ***The Theory of Comparative Advantage and Full Employment***

The list of assumptions that must be satisfied if the theory of comparative advantage can be used to demonstrate the gains from trade (and in so doing support *free* trade) is a long one.<sup>29</sup> It includes perfect competition in goods and factor markets, constant returns to scale in production, identical tastes and technologies, no externalities, free and costless factor mobility *within* countries, fixed labour resources and technologies, trade equilibrium between countries, and full employment of the factors of production. Breaches in all of these in the ‘real world’ have been identified by any number of dissenting economists over the years, but they have proved little barrier to the loyalty to which most economists adhered to the comparative advantage ideal, now, or in the 1940s.<sup>30</sup>

The assumption of concern to the employment approach, and to this paper, is that of full employment. Full employment is a requirement before the gains from trade can be unambiguously specified. Where unemployment exists, an economy is operating at below full capacity and extra production can take place at zero opportunity cost. In such a situation, prices no longer reflect relative scarcities within an economy. Where this is the case, trade between such an economy and another may not produce gains, since the

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<sup>27</sup> *ibid.*

<sup>28</sup> For a sense of the contemporary theoretical underpinnings of international economics at this time, and its close approximation to classical notions, see Haberler (1936).

<sup>29</sup> For a complete exposition of ‘the ‘theory of comparative advantage’ as it would have been understood by economists through the 1940s, see Viner (1937).

<sup>30</sup> For one of the most powerful of these dissenting accounts, see Kaldor ([1984] 1996).

‘actual trade-off or underlying rate of exchange between the production of various goods is theoretically undefined’ (Prasch 1996, p.42). This was recognised by the Australian economists who devised the employment approach as we have seen, but it was not (and is not) recognised by economists generally, who typically assumed full employment and then proceeded to analyse trade on the basis that each country was operating on its production possibilities frontier.

### ***Balance of Payments Adjustment***

Complementing the theory of comparative advantage in the orthodox story of international trade were monetary theories of balance of payments adjustment. Though there were varying versions, most often separated by the degree to which adjustment was seen as automatic or not, all had their core in the specie-flow model of the classical gold standard. While Australia was not being presented with a return of the classical gold standard in the 1940s, the monetary regime that was on offer (after the defeat of Keynes’s Clearing Union in favour of White’s Stabilisation Fund) fundamentally differed little in the way adjustment towards trade equilibrium was seen to occur.<sup>31</sup> Part of Australia’s struggle at Bretton Woods, in addition to seeking recognition of the employment approach itself, was concerned with grafting on to what would become the IMF as many features as possible (reserve facilities, scope for *some* exchange rate flexibility, discipline for creditor as well as debtor nations) that would allow countries to pursue full employment and escape the deflationary and contractionary bias of this regime.<sup>32</sup>

As with the case for free trade generally, by highlighting the full employment *assumption* of this classical model, the employment approach exposed the fragile theoretical underpinnings behind the claims that multilateralism on its own would act as a self-equilibrating mechanism in the international economy. Take, for example, the case most

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<sup>31</sup> The ‘version’ of this adjustment process implicit in the Stabilisation Fund proposal was based around the specie-flow approach, as modified according to the empirical work in the inter-war years of the ‘Harvard School’. This work, which was led by Jacob Viner (but included within the team a young Harry White), found numerous imperfections, but nevertheless concluded that the specie-flow mechanism was broadly correct. For more, see Gomes (1990), pp.152-154.

<sup>32</sup> For more on this, see Turnell (1999).

feared by the Australians - the failure of a large country (though the principle would be the same whatever the size of the country) to maintain full employment. According to the classical story such a scenario, though never an object of analysis under its assumptions, would be corrected as a consequence of the balance of payments surplus in that country, which would be a direct result of its slump in domestic income. The gold flows which would be induced by this surplus would increase the money supply of the country and, according to the Quantity Theory (equally a part of the model), increase nominal income (via a reduction in the bank rate). The difference now, though, was that this increase in nominal income would also include an increase in *real income*, since the assumption that only prices would respond to changes in the money stock no longer held because of the existence of excess capacity. The end result of the application of the classical model to this scenario, with only the assumption of *initial* full employment removed, was that full employment was restored anyway, with the exogenous imposition of unemployment being automatically rectified by the resultant surplus in the balance of payments.

Unfortunately for the classical story, this process was flawed. In the classical model this country enjoyed its balance of payments surplus via an income effect (the reduction in imports as a consequence of unemployment). But all of this depended on the conditions of the classical story remaining valid *everywhere* else. In the story above, the rest of the world had balance of payments deficits with this depressed country and, as a result, lost gold to it. This, in turn, caused a contraction in their money stocks, a rise in bank rates and, assuming all were fully employed to begin with, a decline in prices. With price and wage flexibility, the balance of payments of the rest of the world was restored in turn by the increased demand for their exports via this price effect. What was missing from the classical analysis, however, was a consideration of any income effects upon these exports. With the depressed country initially at less than full employment (the reason, after all, for its surplus) what was the source of the effective demand for the exports of the deficit countries? If it was the depressed country, then the reason for its own recovery via a balance of payments surplus would be removed, and once more unemployment would prevail. At the same time, however, the effective demand could not come from anywhere else. All other countries had experienced a deflationary shock and each

required an improvement in their own balance of payments if internal and external equilibrium was to be restored. All would depend upon the relative price and *income* elasticities of the exports of both the depressed economy and the rest of the world. Thomas Balogh, writing at the same time as the Australians were advancing the employment approach, noted that:

The effects on the demand for any one country's produce of a fall in price are highly conjectural. They will depend on the reactions of competitors in other countries and also on the state of expectations in each of the countries which...are inter-connected. *All countries may well sink and rise together without their international balance, in distinction to the volume of total trade, altering in a significant manner* (Balogh 1944, p.139, emphasis added).<sup>33</sup>

Within the classical model there existed, in short, the possibility that, in the absence of the assumption of full employment, no automatic mechanism existed for restoring balance of payments equilibrium in response to an exogenous deflationary shock. Rather, in the attempts to restore balance, the classical model posited that countries were required to respond via further deflation. But since this would not assuredly work, still further deflation had to follow. There was no reason to suppose that this situation would not continue *ad infinitum*, and the only assured phenomenon was the creation of a global deflationary spiral.

It is important to note that at no stage in the questioning of the self-equilibrating nature of the classical model above, is any reliance placed upon breaches of any of the other limiting assumptions of the orthodox story noted at the beginning of this section, *except* that of the assumption of full employment.

If, however, other 'imperfections' (such as less-than perfectly competitive markets) *were* allowed into the story, the scenario painted above only gets worse. The deflationary spiral remains, but to this would be added the *certainty* that changes in quantities and employment, rather than prices and wages (if these, for example, were no longer supposed to be perfectly flexible), would be the *primary* avenues of adjustment. In the

situation above, the initial deflationary shock from the unemployed country to the rest of the world would produce not just a change in the terms of trade, but immediate unemployment in the rest of the world. The depression, in short, would automatically spread. Countries thus affected could counter this external deflation by internal measures designed to expand effective demand, but these would also exacerbate the balance of payments difficulties. Of course, all of this pointed in the direction of measures to protect the domestic economy from external deflation, and allow it to pursue internal policies which were, at least to a degree, free from the constraints of the external sector. These measures, which could operate via prices (as in the form of tariffs, subsidies, competitive devaluations and so on) or more directly (quotas, reciprocal trade agreements, import licensing, and the like) could also be used to enable countries to maintain domestic demand and employment via a positive external balance. This occurred at the expense of other countries in the form of the ‘beggar-my-neighbour’ policies which had destroyed the global trading and financial system in the inter-war years.

In *The General Theory*, Keynes himself explicitly used the type of reasoning central to the above. Confined to the final two chapters, Keynes warned that the ‘laws’ of comparative advantage applied only *after* domestic demand was at a level sufficient for full employment. In a seminal passage which outlined the lessons of his message for the international economy, he wrote of the hope that

if nations can learn to provide themselves with full employment by their domestic policy...there need be no important economic forces calculated to set the interest of one country against that of its neighbour. There would still be room for the international division of labour and for international lending in appropriate conditions. But there would no longer be a pressing motive why one country need force its wares on another or repulse the offerings of its neighbour, not because this was necessary to enable it to pay for what it wished to purchase, but with the express object of upsetting equilibrium in the balance of payments so as to develop a balance of trade in its own favour. International trade would cease to be what it is, namely, a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle, but a willing and unimpeded exchange of goods and services in conditions of mutual advantage (Keynes 1936, pp.382-383).

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<sup>33</sup> Similar sentiments were echoed in the contemporary literature by Robinson (1937), Shumacher (1943)

The theoretical underpinnings of the employment approach were more soundly established than have ever been credited. In pursuing the employment approach, Australian economists recognised that whilst a country could maintain full employment without free trade, the benefits of free trade could not be delivered without full employment. This message was willfully misunderstood in the 1940s, and it remains so today.

## **V. Concluding comments**

The overwhelming problem of the world economy of the inter-war years was not the growth of barriers to trade, as the orthodox story of international economics would have it, but the collapse of international aggregate demand. The growth of trade barriers and the collapse of international trade were prominent symptoms and effects. The loss of national income from countries failing to take advantage of international specialisation must have been large during this period, but it could only have been a tiny fraction of that lost as a consequence of the extraordinary levels of unemployment experienced by most countries. Attempting to ‘export’ unemployment through the erection of trade barriers only made things worse globally, but it was an understandable response in a system which allowed for little else.

In advocating the employment approach, Australian economists recognised the real problems of achieving stability in the global economy, and identified the real obstacles to achieving it at home. They demonstrated that the gains from specialisation which are the *raison d’être* for free trade, are based upon an explicit assumption of full employment. The gains from free trade are gains that arise from expansion of aggregate supply supported by a concomitant and necessary increase in aggregate demand. However, in the absence of sufficient domestic demand, and with the adoption of the doctrines of ‘sound finance’, export-led growth *at the expense* of one’s neighbours was the only option for domestic prosperity. This is what happened in the inter-war years, and it continues to occur up to the present day.

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and Kalecki (1946).

As it turned out, the postwar years did not live up to the worst expectations of the Australian economists. Because of political, military and other coincidental reasons, the United States provided the global effective demand that alleviated the deflationary bias implicit in the international monetary arrangements established at Bretton Woods. This period demonstrated empirically the correctness of the Australian position that they had established theoretically. Although lasting from around 1949 to 1973, this period could not endure because of the temporary circumstances prevailing in one country alone. It served as a limited reminder, nevertheless, of what was possible.

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